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THE EFFECT OF COMPANY INCOME TAX ON DIVIDEND POLICY OF FINANCIAL INSTITUTIONS IN NIGERIA

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ABSTRACT
This study appraised the effect of company income tax on dividend policy of financial institutions in Nigeria. In doing this, the researcher attempted to examine the nature and history of taxation in Nigeria; explain the meaning and types of dividend policy and examine the relationship between corporate income tax and dividend policy of financial institutions in Nigeria. To enable an empirical comparison of the findings, a critical review of related literature was carried out. A survey research method was used in the study. The analytical tools used in analyzing the data collected for the study was regression analytical techniques. Data was obtained from the published accounts of fifteen financial institutions in Nigeria. It was discovered that there is significant relationship between corporate income tax and dividend policy of the financial institutions in Nigeria.

KEYWORDS: Company Income Tax, Dividend Policy, Nigeria Stock Exchange, Dividend Payout, Financial Institutions, Retained Earnings

INTRODUCTION

Dividend policy is the core component of a firm's overall financial policy. It is comprised of a series of decisions regarding how the firms distribute profits to their shareholders and it mostly includes basic contents about the selection of dividend policy, dividend payout ratio and payout channel etc. Since the dividend policy determines whether distribute the earnings to shareholders or self-finance through retained earnings, so it is an important issue that receives more attention these days from both academics and practitioners (Li *et al*., 2006). Corporate income tax is one of the major sources of revenue to all governments. In Nigeria, it is a factor to be reckoned with in Federal Government's budget. The taxes so collected come back to the taxpayers in form of services and to either encouraged or discouraged some activities in the private sector; though, this depends on whether the policy of the government is towards discouraging or encouraging such companies (Ola, 1999).

A lot of controversies regarding taxes and dividend policy have attracted many academic interests. The debate over the importance of dividend policy was first sparked in Miller and Modigliani (1961), which suggested that both firm financing and dividend policy was irrelevant for firm investment decisions and independent of the value of the firm (Elston, 1999). Financial theorists such as Brennan (1970), Masulis and Trueman (1988) have stipulated that taxes affect organisational corporate dividend policy. If this speculation were true, changes in corporate dividend payout would be expected whenever the government changes its income tax policy (Wu, 1996). However, this does not always apply especially in the banking business. Lintner (1956) had asserted that the major determinants of dividend policy are the anticipated level of future earnings and the pattern of past dividend. This discrepancy may have underpinned Modigliani and Miller (1961) theory, which provided a platform for the enormous debates and researches on dividend policy. The financial sector is of interest in this research because of the structure of its dividend as revealed in the study.

Dividends are usually paid to owners or shareholders of business at specific periods. This is apparently based on the declared earning of the company and the recommendations made by its directors. Thus, if there are no profits made, dividends are not declared. But when profits are made, the company is obligated to pay corporate tax including other statutory taxes to the government. This is an essential corporate responsibility particularly profit making companies. The taxes no doubt reduce the profits available at the disposal of the organisations, either to be retained or distributed as a dividend to shareholders of the company. Dividend policy is the trade-off between retaining earning and paying out cash or issuing new shares to shareholders. Some firms may have low dividend payout because management is optimistic about the firm's future and therefore wishes to retain their earnings for further expansion. Frankfurter and Wood (1997) indicate, dividend pattern of a firm is a cultural phenomenon that changes continuously in relation to environment and time. It is hard to deny that taxes are important to investors. Although,

dividend affects the shareholders tax liability, it does not in general alter the taxes that must be paid regardless of whether the company distributes or retains its profit (Brealey, Myers and Marcus, 1991).

Taxation is not a new word in Nigeria or the world as a whole. In Nigeria, taxation has been in existence even before the coming of the colonial men or the British. Taxation can be defined as the system of imposing a compulsory levy on all income, goods, services and properties of individuals, partnership, trustees, executorships and companies by the government (Yunusa, 2003). Anyafo (1996) defined taxation as a compulsory payment made by individuals and organization to relevant Inland Revenue authorities at the federal, state or local government level. Tobansi-Ochiogu (1994) sees taxation as a levy imposed by the government against the income, profit or wealth of the individual, partnership, corporate organization. Ola (1999) defined taxation as compulsory levy imposed on a subject or upon his property by the government to provide security, social amenities and create conditions for the economic well-being of the society. Tax is not an assessment of benefits. It is a means of distributing the burden of the cost of government (Jones, 1998). This study shall be directed at evaluating the effects of company income taxes on the dividend policy of financial institutions in Nigeria.

The main objective of this study is to appraise the effect of corporate income tax on dividend policy of financial institutions in Nigeria. Specifically, this study intended to:

I. Explain the nature and history of taxation in Nigeria.
II. Explain the meaning and types of dividend policy.
III. Examine the relationship between corporate income tax and dividend policy of financial institutions in Nigeria.

To examine the impact of corporate income tax on dividend policy of financial institution in Nigeria critically and objectively, the following null hypothesis was formulated and tested:

H_o: There is no significant relationship between company income tax and dividend of financial institutions in Nigeria.

Company Income Tax in Nigeria: Nature and history

Income tax is one of the major sources of revenue to all government. In Nigeria, it is a factor to be reckoned with in Federal Government’s budget the taxes so collected come back to the tax has over the years encouraged or discouraged some activities in the private sector; though, this depends on whether the policy of the government is towards discouraging or encouraging such companies (Ola,1999).

According to Azubike (2007), the history of taxation in Nigeria can be dated back to the era of Sahara trade and the introduction of Islamic religion in Nigeria between 800AD and 1400AD. The rulers in the Northern Nigeria were known as “Safawa”, Kings, who grew rich due to gifts and levies paid to them by their subordinates as taxes on cattle and agricultural crops. The Islamic religion later introduced various forms of taxes namely: Zakat, Kurdin Kasa, Shukka Shukka, Jangalia, Kharant etc. The Zakat was imposed on educational and charitable purposes. In the south, the Obas and Ezes relied on tributes, arbitrary levies, special contributions at special festivals or events, fees, present, all collected through the head of families as it system of taxation. The first legal backing of taxation was in 1904 when Sir Frederick Lugard introduced the Native Revenue Proclamation. This proclamation was further enhanced in 1906. After independence in 1960, the government enacted three major tax laws, namely: Federal Income Tax Act (FITA), 1961; Income Tax Management Act (ITMA), 1961 and Companies Income Tax Act (CITA), 1961. The companies Income Tax Act (CITA) 1961 was applied to companies in Nigeria. It was later repealed and replaced with the companies Income Tax Act (CITA) 1979 with amendment in 1993 up to 1999. The Act is contained in chapter 60, Laws of the Federation of Nigeria (LFN) 1990. It is the sole responsibility of the Federal government to administer corporate Income taxes in Nigeria.

Meaning and Types of Dividend Policy

In discussing the meaning of dividend policy, it is important to highlight what a dividend is. A dividend is simply the money that a company pays out to its shareholders from the profits it has made (Droughty, 2000). Such payments can be made in cash or by issuing of additional shares as in script dividend. Davies and Pain (2002) however defined it as the amount payable to shareholders from profit or distributable reserves. Companies that are listed in the stock exchange are usually obligated to pay out dividends on a quarterly or semi annual basis. The semi

annual or quarterly payment is referred to as the interim dividend. The final payment, which is usually paid at the end of the financial year of the company, is known as the final dividend. Dividends are normally paid after the corporate tax has been deducted.

Dividend policy is primarily concerned with the decisions regarding dividend payout and retention. It is a decision that considers the amount of profits to be retained by the company and that to be distributed to the shareholders of the company (Watson and Head, 2004). Theoretically, there are different types of dividend policies. These include constant payout, progressive policy, residual policy, and zero policy and non-cash policy. Investors are seen to belong to a particular group or clientele. This is because they tend to pitch their tent with a particular policy that might suite them. This is the clientele effect of dividend policy (Hutchinson, 1995; Kolb and Rodriguez, 1996).

(i) Constant or fixed policy: The Company pays out a fixed amount of its profit after tax as dividend. Thus, the company maintains a fixed payout ratio of dividend. Pandey (2005) define payout as the ratio of dividend to earnings. A company may as a matter of policy, decide to constantly payout sixty percent of its after tax profit as dividend to its shareholders and retaining the remaining fraction. This type of policy allows the shareholders the opportunity to clearly know the amount of dividend to expect from their investments in the company. However as noted by Watson and Head (2004), the policy could be traumatic to companies experiencing a volatile or fluctuating profit earning. This is because of the uncertainty of its profit. If capital projects are to viable capital projects, the policy can be chaotic.

(ii) Progressive policy: Payments on dividend is on a steady increase usually in line with inflation. This could result in increasing dividend in money terms. The firm uses the policy as a ratchet. Every effort is made to sustain the increase even though marginal. Seldom, the company may be constrained to cut down on dividend payout. This is to enable it sustain its operations. This though not a frequent action as it sends a wrong signal to investors. Firms operating this policy will opt to avoid paying dividends during the period rather than consistently cut down on the dividend (Kolb and Rodriguez, 1996).

(iii) Residual policy: Dividends are just what is left after the company determines the retained profits required for the future investment. This policy gives preference to its positive NPV (Net Present Value) projects and paying out dividends if there are still left over funds available. Dividend becomes a circumstantial payment only paid when the investment policy is satisfied. There is a tendency therefore that this type of policy could give rise to a zero dividend structure. Firms may need to modify this policy to ensure that investors of the different clienteles are not chased out by a strict application of the policy (Kolb and Rodriguez, 1996).

(iv) Zero dividend policy: Some firms may decide not to pay dividend. This is especially common in newly formed companies that rather require capital to execute its projects. All the profit is thus retained for expansion of the business. Investors who prefer capital gains to dividends because of taxation will naturally be lured by this kind of policy. This type of policy is quite easy to operate and avoids all the costs associated with payment of dividends (Watson and Head, 2004).

(v) Alternative policies: In order to give shareholders a choice between dividends or new shares, the company might choose to buy back shares. This is share or stock repurchase. This has a significant advantage in terms of tax to the shareholder. While the dividend is fully taxed just as ordinary income, the stock repurchase or buyback is not taxed until the shares are sold and the shareholder makes a profit or capital gain (Ross, Westerfield and Jordan, 2001). There is also the policy of stock dividends and split. Shareholders are given additional shares in lieu of cash to the shareholders (Brealey, Myers and Marcus, 1999).

MATERIALS AND METHODS

A survey research method was used for the study. The major source of data shall be through the published accounts of financial institutions in Nigeria. Though, relevant literatures including periodicals and journal articles giving clues on the investment decision/policy, taxation etc also provide veritable data for the analysis. The research was both qualitative and quantitative in its approach. The qualitative approach includes detail description explanation of a phenomenon under study while the quantitative approach involves the use of numbers (Encarta Dictionaries, 2009). The methodology was empirical as it will implore statistical tools in analysing data obtained for the study. The analytical tools used in analyzing the data collected for the study was regression analytical techniques. It has the

potential of predicting the values of the dependent variable given values of the independent variable (Martin and Firth, 1983). The study population consists of all staff of financial institutions in Nigeria quoted on the Nigeria Stock Exchange (NSE). A systematic sampling technique was used to select fifteen financial institutions in Nigeria. The choice of the systematic Sampling technique was in order to get convenient samples that will be an adequate representation of the study. This has the advantage of eliminating possible bias particularly in a survey (Smith, 1991).

RESULTS AND DISCUSSION

Table 1 and Table 2 show the Regression Summary and Coefficient of the dependent and independent variables used to determine the relationship that exists between corporate income tax and dividend policy of financial institutions in Nigeria via SPSS package (version 17.0).

Table 1: Regression Summary

Model	R	R Square	Std Error of the Estimate	Sig. F Change
1	.552	.305	2779.540	.033

Source: SPSS Output File

Table 2: Coefficients

Model	Unstandardized Coefficients		Standardized Coefficient	t	Sig.
	B	Std. Error	Beta		
Constant	494.657	1283.841		.385	.706
Tax	.884	.370	.552	2.388	.033

Source: SPSS Output File

Tables 1 and 2 show the Correlation between tax and dividend of fifteen financial institutions used in the study. The correlation shows a perfect positive correlation between the tax and dividend. This indicates that tax weigh heavily on the determination of dividend policy of financial institutions in Nigeria. In table 1 the value of R, coefficient of correlation, is 0.552 which indicates a positive but moderate relationship between tax and dividend while the coefficient of determination (r^2) is 0.305 which mean that about 31% of the dependent variable is accounted for by the independent variable and the remaining 79% is accounted for by other variables. The positive relationship implies that as dividend increases, corporate tax increases. In table 2, the regression coefficient is 0.884 and the t-statistics is 2.388. The level of significance/p-value is 0.033; this is 3.3% level of significance. That mean 96.7% confidence interval which mean it is significant because its more than 95% confidence level and less than 5% significant level. The significant level shows that the independent variable (tax) may necessarily be contributing to the variation in the dependent variable (dividend). Therefore, the null hypothesis is not true, as the simple regression analysis shows a significant effect of corporate income tax on dividend. This implies therefore that a change in tax will significantly affect the dividend policy of the financial institutions in Nigeria.

The discussion of the findings of the study is based entirely on the research hypothesis, which is in line with the research objectives. Dividends are taxed at shareholders marginal tax rate, while capital gains first are only taxed when realized, and second, have a lower tax rate than the highest marginal personal tax rate. A high dividend policy is justified if a firm does not have any good investment uses for its cash. It is better to return money to the shareholders rather than invest in negative net present value projects, such as holding cash. Ross, Westerfield and Jordan (2001) highlight that effective tax rates on dividend income are higher than the tax rates on capital gains. The dividends are taxed as ordinary income while the capital gains are taxed at a relatively lower rate and are taxed when the shares are sold. Thus, these options of accepting a cash dividend or differing it for a capital gain explains the significant effect of the tax on the dividend as obtained in the study. A low dividend policy is justified to minimize shareholders' personal taxes. A high dividend policy could hypothetically make sense in a tax system with higher

rates on capital gains than on dividends. Similarly, if a firm's shareholders are exempt from taxation, then the rationale for paying low dividends would be reduced. The low dividend and extra policy is not appropriate for firms in all industries. It is best for companies in industries where firms infrequently experience large but temporary increases in earnings. It is not appropriate for firms with high, steady earnings. Mature, low growth firms are more likely to follow a constant nominal payment, increasing the dividend regularly as earnings increase.

CONCLUSION

Based on the results and discussions above, the following conclusions can be deduced:
The result of the study is consistent with the findings of scholars and researchers with similar interest such as Jensen and Johnson (1995); Miller and Scholes (1978, 1982). This study provides additional evidence that corporate income tax affect the dividend policy of corporate organizations.

There is a significant relationship between corporate income tax and dividend policy of financial institutions in Nigeria. Therefore, a change in corporate income tax rate will significantly affect the dividend policy of financial institutions in Nigeria.

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